SCHOOL OF ACCOUNTANCY

THE EFFECTIVENESS OF THE INTRODUCTION OF SECTION 7C INTO THE INCOME TAX ACT TO CURB THE AVOIDANCE OF TAXATION THROUGH THE USE OF TRUSTS

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation)

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ABSTRACT

Trusts are an essential tool for estate planning. The interest in trust structures by taxpayers has increased over the years and the South African Revenue Services ('SARS') and National Treasury ('NT') have placed trusts on their agenda due to their perceived tax avoidance resulting from the use of trust structures. Section 7C was introduced into the Income Tax Act 58 of 1962 (as amended) ('the Act') in order to curb the avoidance of estate duty. However, the work undertaken by SARS and NT over the years and the insertion of this section in the Act, created an impression that there is avoidance of taxation through the use of trust structures. This study will interrogate the provisions of s 7C in order to determine the effectiveness of this section in curbing the avoidance of estate duty and/or tax through the use of trust structures. The well thought out manner in which this section was drafted and the existence of other tax provisions in the Act which pertain to trusts and the funding mechanisms of trusts suggest that this new inclusion is a convenient and easy manner to monitor the abuse by SARS and NT and subsequently curb the perceived abuse. The interplay of this section with ss 7 and 31 of the Act indicate a risk of unintended double taxation. This and the circumvention options that taxpayers may embark on are matters that may render the section ineffective, although it is evidenced that this section closes that last door that remained open for taxpayers in respect of funding a trust.

Key Words: Tax avoidance, estate duty avoidance, National Treasury, SARS, National Budget Speech, Davis Tax Committee Reports on estate duty, Interest-free and low interest loans, Affected Transactions (s 31), Donor attribution rules (s 7), Donations and donations tax, Double taxation.

DECLARATION

I declare that this research report is my own unaided work. Although unaided, I conducted interviews on the relevant aspects of the research title with various Tax Professionals within the Tax fraternity, the responses of which are outlined in the study below. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

Tshepisho Lucy Mukoma
April 2017

To my daughter,
with sincere thanks
for her patience and understanding
during the writing of this research report.

PREFACE

The research question was mainly motivated by my passion for trusts and taxation implications pertaining to trusts. This research question was further motivated by its current relevance in the Tax fraternity. The research question is very relevant amongst taxpayers and still leaves unanswered questions in one's mind. It is also an immense subject matter in my line of employ and has been a discussion point amongst my colleagues and clients. Due its novelty, there is not a lot of historical material on this research question and as such I would like to thank the following Tax Professionals who afforded me their time in partaking in the interview process on this research question and for their permission to use their responses in the research report:

Mr Leon Coetzee
Head of Tax, FirstRand Bank Limited, Banking Association of South Africa ('BASA') Chairperson and Commercial member of the Tax Court of South Africa.

Mr Hugo Van Zyl
Local & Global Solutions Specialist, FNB Fiduciary, CA(SA), TEP, MTP(SA).

Mr Kyle Mandy
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Adv. Gert Van Der Bergh (Advocate)
Director at Delport Van Den Bergh, specialising in Trusts.

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1. PRELIMINARY MATTER

South African residents have been and continue to make use of trusts as part of their estate planning. In setting up trusts and depending on the needs of the taxpayer, various structures are put in place. SARS and NT developed an uncorroborated view to the effect that there is estate duty and tax avoidance arising from the use of trust structures, where the loudest noise was mainly in respect of tax avoidance. Although in principle, s 7C is aimed at curbing the avoidance of estate duty, the journey to the promulgation of this section was mainly lead by a perceived view that there is an avoidance of taxation. As such, the study will mainly focus on the avoidance of tax and aspects relating to the avoidance of estate duty will indirectly form part of the study.

The 2013 National Budget Speech was the first confirmation of the views of both SARS and NT. For the purposes of this study, these bodies will be referred to as regulatory bodies. It was from this point in time that future proposed measures of curbing the perceived tax avoidance were announced to be put in place. Following from this announcement, various measures were raised in the Davis Tax Committee Interim Reports on estate duty and the 2016 National Budget Speech which resulted in the introduction of s 7C into the Act. These proposed measures and the introduction of s 7C were aimed at curbing the avoidance of taxation and estate duty, respectively, through the use of trust structures. From all the proposed measures, s 7C is the only promulgated measure.

Although it is aimed at preventing the perceived abuse of estate duty, based on the main reasons behind all the work conducted by the regulatory bodies, which was mainly around preventing the avoidance of tax and the insertion of this section in the Act both created an impression that s 7C was brought in to prevent the abuse of taxation in respect of trust structures. It goes without saying that anti-avoidance of estate duty should be and is best addressed in the estate duty Act. Using the Act to address this avoidance is questionable and results in confusion in respect of the intention of this section. As such, it could be argued on strong grounds that s 7C was brought in to prevent the avoidance of taxation.

With this in mind, it is yet to be determined as to whether the provisions of this section achieved the goal of the regulatory bodies in curbing the avoidance of taxation.

This study will interrogate the introduction of this section with the aim of concluding on its effectiveness in achieving its set purpose.

1.1 The attention afforded to trusts by the regulatory bodies

In the recent past years, trusts have been afforded a considerable amount of attention by the regulatory bodies. This appears to have come about as SARS is under immense pressure to collect revenue from taxpayers and aligning itself with the principles of Base-Erosion and Profit-Shifting (‘BEPS’) measures. These measures directed the regulatory bodies back to the drawing table where investigations took place to identify and prevent structures where potential tax avoidance existed. As such, trust structures were identified as one of the pertinent areas to focus on as there is tax avoidance. This is however uncorroborated.

Due to the intensity of the regulatory bodies to prevent the perceived abuse and due to the failure by these regulatory bodies to substantiate their perceived view of tax avoidance (or estate duty avoidance), taxpayers undertook to identify the reasons for the view of abuse, either in respect of taxation or estate duty.

As such, taxpayers investigated the reasons for trust creations in order to determine whether trusts are indeed created for an avoidance of taxation. Furthermore, taxpayers conducted calculations in order to have a demonstration of the avoidance of tax through the use of trusts.

The outcome of the above is that most and if not all trusts are created for purposes of estate planning, specifically for asset protection. This resulted in a concern by the industry that the regulatory bodies have not conducted the required homework on which to base their view. It is therefore questioned that if trusts are created for asset protection purposes, what then justifies the view that there is tax avoidance through these structures?

In looking at this factor from a different angle, industry role players in the Tax fraternity conducted calculations with the aim of proving that SARS is indeed losing out on the collection of taxes due to trusts structures and thereby seeking to prove the perceived analogy of the avoidance of tax by SARS. It was found in these calculations that there is a tax event when an asset is placed in the trust, whilst the asset is sitting in the trust and on the growth of that asset, upon disposal or death of the donor or dissolution of a trust. The calculations proved that SARS collects more tax than loses out, through the use of trust structures.

Though this fact was communicated to SARS, this did not deter the regulatory bodies from persisting with the work of curbing the unsubstantiated, perceived tax avoidance. Perhaps this could be due to the fact that the industry's corroborated results were not in line with those utilised by the regulatory bodies to substantiate the abuse. Although a taxpayer uses a vehicle for the right reasons, it does not necessarily mean that there is no tax avoidance, perhaps in the manner in which the current legislation is drafted or the lack of a required section in the Act, thereof. As such, it remains the business of the regulatory bodies to investigate such anomalies and provide amendments or introduce new sections in the Act in order to give effect to the South African tax legislation.

Furthermore, although the calculations prove that SARS is not in effect losing out on revenue collection, it is important for taxpayers to differentiate between tax avoidance and loss to the fiscus in terms of revenue collections. These two aspects are different and although in some instances they may be linked, they should be addressed differently. It follows therefore that the regulatory bodies introduced s 7C to address tax avoidance and not necessarily the revenue loss to the fiscus.

Following from this, trust structures commenced to obtain more attention from SARS and NT.

As mentioned, South Africans have always made use of trusts for estate planning purposes. However, it is viewed that some taxpayers used trust structures for tax planning purposes which resulted in tax avoidance. In other words, trust structures may have been used to either transport funds out of South Africa into a sham trust or South African resident taxpayers may have used a valid trust to transport funds out of South Africa with the aim of avoiding South African taxation. Furthermore, some funding mechanisms of a trust may be seen to avoid tax in that not all the tax that pertains to such mechanism is effectively collected. Further to this is the manner in which trusts are taxed in terms of South African tax regulation.

Although trusts still remain a useful estate planning tool, especially for asset protection purposes, SARS and NT view these structures as an enabling tool to avoid taxation. As such, preventative measures were explored with the aim of curbing the tax abuse created by trusts.

2. CHAPTER 1 – INTRODUCTION

2.1 Proposed measures undertaken to curb the avoidance of tax through the use of trusts

Over the past years, various measures were proposed to be put in place for the avoidance of tax through trusts.

2.1.1. The 2013 Budget Speech by the Minister of Finance

The initial measure undertaken by SARS and NT was announced in the 2013 National Budget Speech. In his 2013 Budget Speech, the Minister of Finance announced that ‘there will be measures to reform the taxation of trusts to curtail the avoidance of tax associated with trusts’. This announcement reaffirmed the views of the regulatory bodies in respect of trusts. Based on this announcement, it can be evidenced that the proposed measures, at the time, were not directed at the form or the structure of a trust as per the principles of common law. They were directed at the manner in which trusts are taxed.

The form of a trust was introduced into the Cape Colony. Following from this point, the Courts of Common Law also defined and prescribed a trust form. A trust was defined in the Hague Convention as a legal relationship created during the lifetime of the donor or on death of the donor, where the donor places assets under the control of a trustee for the benefit of a beneficiary.

The divesting of the ownership of assets from the donor to the trustees is a principle that is in line and is required by Roman-Dutch civil law. South Africa follows this civil law for trusts. The principles of Contract law are also used in South Africa in order to give effect to trust deeds. In essence, the trust form, although prescribed by various laws, has been accepted into South African law.

South African trust law is not cast in stone and as such, it remains a subject matter that is subject to various interpretations. However, it took a number of years for South Africa to conclude on a consistent interpretation of a trust form. As such, an amendment to the form of a trust would create major disruptions in the trust fraternity.

The regulatory bodies were also mindful of the potential disruptions and such they did not propose a measure that would impact a trust form. The indicated measure was directed to the taxation of trusts.

The South African tax law subjects persons, as defined in section 1 of the Act, to taxation. In order to provide clarity on the taxation of trusts, trusts were included in the definition of a "person" in the Act, in 1991. It was from this point that trusts, in their capacity as a person for tax purposes, were subject to taxation.

The form of a trust and the manner in which income of a trust is handled may however result in peculiar taxing mechanisms. In other words, the tax implications of a trust are dependent on the source of its income and the distribution methods of a trust. This means that the income of a trust may be taxed either in the trust itself, the donor or the beneficiaries. This however depends on whether a trust is a discretionary or vested trust. The peculiarity arises in respect of discretionary trusts as in a vested trust, where the beneficiaries have full vested rights to both the income and capital of the trusts; the taxation implications follow the beneficiaries and not the trust.

This taxing method stems from the principles of case law[1] where it was held that a trust is a mere conduit pipe through which the income flows, and the income retains its identity in the hands of the beneficiaries. It is for this reason that various applicable provisions of the Act must always be consulted in identifying the taxpayer liable for tax on the income or capital of the trust.

As mentioned above, the tax liability may be of the donor, beneficiaries or the trust. In identifying the applicable provisions, ss 7(2), (3), (4) and (8) of the Act must be used for purposes of the donor. Sections 25B and 7(1) are applicable to the beneficiaries and the trust is taxed where s 25B(1) applies.

Currently, the highest income tax rate applicable to a trust and a natural person is 45%, as recently announced in the 2017 National Budget Speech. However, this rate is fixed for a trust (other than a special trust) and is flexible in respect of natural persons, depending on the applicable rate. The income tax rates for natural persons range from 18% to 45%. In this respect, there is room for diversion of income into the hands of the person with the lowest income tax rate applicable to them. In other words, the trust may distribute all its income into the hands of a beneficiary who is taxed at 18% instead of holding the income in the trust and suffer tax at 45%.

It can be evidenced from the above that there is flexibility in respect of the taxation of trusts.

[1] *Armstrong v CIR 1938 AD 343 10 SATC 1*

Due to the fact that the perceived view of the regulatory bodies was not substantiated, a view could be developed that it is this flexibility that resulted in the announcement by the Minister of Finance to reform the taxation of trusts to curtail the avoidance of tax.

There was no further elaboration on this announcement and as such the industry digested the views of these two regulatory bodies and yearned for further provision of details in this respect.

In the same Budget Speech, the Minister further stated that discretionary trusts will no longer act as flow through vehicles. It is to this point that it could be concluded that the concerns of SARS and NT are in respect of discretionary trusts and the manner in which they are taxed in terms of South African tax principles. As discussed above, the concern in respect of these types of trusts is in respect of the flexibility of the taxation of these types of trusts and the fact that it is viewed that this flexibility results in the avoidance of taxation. This flexibility in relation to discretionary trusts resulted in the discomfort by the regulatory bodies and thereby resulted in a proposal to amend the current taxing methodology of discretionary trusts.

The principles of case law[2] were used as prescription in respect of the manner in which a trust is taxed. As such, these principles have been used and relied upon in South Africa for many decades. It was held in a case, <u>that the income of a trust retains its nature only if it accrues to the beneficiaries in the same year of assessment as it accrued to the trust</u>[3]. Any accumulated income in the trust would normally already have been taxed in the hands of the trust or donor (emphasis).

It is therefore clear that a lot of historical effort contributed to the current tax laws. The doing away of the conduit pipe principle (also referred to as the flow through principle) endured major attack by the industry as it contradicts the characteristics of a trust.

This announcement, in essence, was aimed at making the trust the only person that will be subject to taxation in respect of all the income and capital of the trust. This will mean that the tax implications arising as a result of the attribution and distribution principles of a trust will be done away with and the principles of the *Armstrong* and *Rosen* cases will no longer prevail.

Due to potential disruptions that this would have caused and the attacks from the industry, there was no amendment to effect any of the above announcements in the Taxation Laws Amendment Bill of 2013 and 2014. However, the regulatory bodies did not halt their exertion on curbing the avoidance of tax through trusts. As such, a further mentioned by way of a recommendation was evidenced in the First Interim Report on Estate Duty, by the Davis Tax Committee.

2.1.2. The 2015 Davis Tax Committee First Interim Report on estate duty

[2] *Armstrong v CIR 1938 AD 343 10 SATC 1 and SIR v Rosen 1971 (1) SA 173 (A), 32 SATC 249*
[3] *SIR v Rosen 1971 (1) SA 173 (A), 32 SATC 249*

The Davis Tax Committee was established in 2013 and is chaired by Judge Dennis Davis. It was established with the objective to assess South Africa's tax policy framework and its role is to support the objectives of inclusive growth, employment, development and fiscal sustainability. As part of its mandate in reviewing the South African tax policy, there was an immediate need by the Davis Tax Committee ('DTC') to address BEPS. A part of this involved an investigation of the avoidance of estate duty and tax through the use of trusts structures.

In July 2015, the DTC released its first interim report on estate duty for public comment. It was recommended in this report that the "attribution principle" for trusts should be repealed. The attribution principle is in line with what is discussed above, where the income of a trust can be attributed back and be taxed in the hands of a donor.

This recommendation was substantiated by the fact that the attribution principle is governed by the provisions of s 7 of the Act. Section 7 was originally intended as an anti-avoidance measure with the effect of preventing a trust from being used as an income-splitting vehicle. However, the attribution principle is currently used to avoid tax. This therefore defeats the intended purpose of this section.

Further to this recommendation, the DTC alluded to a perceived donations tax avoidance whereby assets are transferred to a trust on loan account. The loan would be an interest-free loan and would be left to remain outstanding until the death of the donor.

In this respect, the following recommendations, amongst others, were outlined in this first interim report:

- The flat rate for trusts should be maintained at its existing levels and trusts should be taxed as separate taxpayers;
- The deeming provisions of ss 7 and 25B should be repealed in respect of local trusts (and should remain in respect of offshore trusts; and
- No attempt should be made to implement transfer pricing adjustments in the event of interest-free loans to trusts.

Two themes, which are of great concern to the DTC, are evidenced in their recommendations. One being the avoidance of tax caused by the attribution principle and secondly, the avoidance of donations tax which results from advancing interest-free loans to a trust.

The avoidance of tax due to the attribution principle is clearly the doing of the regulatory bodies as they drafted and promulgated ss 7 and 25. As discussed above, the drafting of these two sections were aligned to the principles of the Armstrong and Rosen cases. Although amendments to constantly curb tax avoidance are necessary, it is prejudicial to resort to doing away with what was their work (in drafting the legislation) purely because taxpayers use the provisions of these sections to their advantage. It is observed that the regulatory bodies are failing to acknowledge the extensive effort that was afforded in deriving the current taxation principles of trusts and to erase this from the taxing principles without an alternative workable solution is not an answer.

It goes without saying that this recommendation was condemned by the industry to its demise. As a result, there was no further mention of this recommendation or its execution.

The report of the DTC alluded to what can be viewed as the second theme of concerns, being the curtailing of the use of interest-free loans to avoid donations taxation.

The taxation of donations is outlined in s 54 of the Act. It is defined therein that a donation is any gratuitous disposal of property including any gratuitous waiver or renunciation of a right. The question that arises is whether an outright advancement of an interest-free loan is a donation? In other words, would the forgone interest constitute a donation to the trust?

A loan that is outright stipulated as an interest-free loan could mean that the lender gratuitously waivers any right to interest on the loan. Based on this, it could therefore be the view that an interest-free loan results in the donation of the forgone interest. In this case then, why is there a need for recommendations by the DTC and further work by the regulatory bodies on interest-free loans as the forgone interest is clearly a donation that is subject to the provisions of s54?

It follows however, that a donation that is a *donatio mortis causa* and a donation that is in pursuance of a trust are exempt from donations tax. With this in mind, it appears that, although interest-free loans seemingly result in a donation of the forgone interest, these exemptions may apply to an interest-free loan. This however depends on the circumstances around the advancing of the loan.

A donation that is a *donatio mortis causa* is a donation that takes place and is effected upon the death of the donor (or when the donor contemplates his death). An interest-free loan is ordinarily advanced and is effective in the hands of the trust whilst the donor is alive (and not necessarily when he anticipates his death). In this case, it cannot be said that the interest-free element of the loan only kicks in upon death as this element is effective concurrently with the advancing of the loan. In this respect, this exemption is not applicable in respect of the ordinary interest-free loans advanced to trusts by lenders.

Furthermore, a loan that is advanced in pursuance of a trust is also exempt from donations tax. There are differing industry views in respect of the interpretation of this exemption however. This is mainly in respect of the term “in pursuance”. In pursuance of a trust could mean in relation to a trust (on an ongoing basis) or the initial funding of a trust (applying only in respect of the first interest-free loan to a trust).

The dictionary meaning of this word/ term is ‘carrying out’. Carrying out a trust could be seen to be a once off or a continuous act, hence the differing views.

A different view has been alluded to this exemption, to the effect that this exemption relates to a distribution by a trust to the beneficiaries of the trust and further reaffirms that donations to a trust are subject to donations tax[4]. In applying this interpretation, it follows therefore that all donations to a trust, including interest forgone as a result of interest-free loans are subject to donations tax as the exemption does not apply.

On a different angle however, it is not mandatory to charge interest on a loan. This is evidenced in case law[5]. As such, it cannot necessarily be concluded that an interest-free loan results in a gratuitous act. Charging of interest is optional and the advancing of an interest-free loan does not meet the requirements of s 54. As such, interest-free loans are not donations as per s 54 of the Act. However, interest-free loans can be viewed as a disposition and be treated as a deemed donation in terms of the provisions of s 7. This then justifies the need for further work by the regulatory bodies as there may be a view of a loophole in respect of the levying of donations tax on interest-free loans.

Seeing that forgone interest constitutes a deemed donation and is subjected to the provisions of s 7, it is further questioned as to why are the regulatory bodies and the DTC are still of the view that this type of funding mechanism results in the avoidance of tax? This is due to the fact that this funding mechanism is already addressed in the provisions of s7.

As elaborated above and previously stated above, the view of the regulatory bodies is unsubstantiated. They nevertheless continued with further proposals in respect of this view.

2.1.3. The 2016 National Budget Speech by the Minister of Finance

The Minister of Finance continued with the measures in respect of trusts in his 2016 Budget Speech where he announced that assets transferred through a loan to a trust are to be included in the estate of the founder at death. This announcement was directed at the limiting of the avoidance of estate duty and not so much taxation. Perhaps this may be viewed as an acknowledgement by the regulatory bodies that interest-free loans result in the avoidance of estate duty and not taxation.

The Minister further announced that they will categorise interest-free loans to a trust as donations, thereby triggering donations tax. This focus by the Minister, on interest-free loans is consistent with the concern raised by the DTC whereby it is clearly concluded that taxpayers are avoiding donations tax through the use of interest-free loans.

As discussed above, the forgone interest in relation to an interest-free loan meets the definition of a deemed donation in terms of the provisions of s 7 and should already be subject to the taxing provisions of s7.

This consistent view by all these bodies could mean that –

[4] Silke: South African Income Tax, Volume 2: 2017, 816

[5] *C: SARS v Brummeria Renaissance (Pty) Ltd 2007 (6) SA 601 (SCA), 69 SATC 205 (SCA), [2007] 4 All SA 1338 (SCA), (2007) 69 SATC 205*

- The regulatory bodies acknowledge the flaws in respect of the interpretation of a donation/ deemed donation, whereby there could be room for taxpayers to argue out of a donation in respect of the forgone interest as a result of an interest-free loan; or

- The regulatory bodies acknowledge the flaws in respect of the interpretation of the exemptions from donations tax in respect of trusts in s 56, specifically in relation to a pursuance of a trust, whereby taxpayers may interpret the exemption to apply to any donation to a trust thereby nullifying the applicability of ss 54 and 7 to donations made to trust. This would result in the avoidance of donations tax in respect of interest-free loans to trusts; or

- The regulatory bodies, although the Act provides for anti-avoidance measures in respect of interest-free loans to trusts, have failed to effectively monitor the non-compliance with respect to the applicable provisions of the Act. As a result, they embark on a complete new regulation which they perhaps will be able to effectively administer and monitor.

Announcements in the Budget Speech are not legislation unless gazetted into law and the public awaited a legislative amendment or addition which will enforce the measures proposed by the regulatory bodies and the DTC. As such, the draft Tax Laws Amendment Bill which was released in July 2016 contained an insertion of a new proposed section aimed at interest-free loans to trusts, namely s7C.

2.1.4. The proposed new section 7C inserted in the Tax Laws Amendment Bill, released July 2016

As awaited for by the public, the new proposed s 7C was inserted into the draft Tax Laws Amendment Bill ('the Bill') in July 2016 for public commentary.

When initially brought into the Bill, s 7C was aimed at interest-free loans or low interest loans to trusts by connected persons whereby the forgone interest was to result in <u>gross income</u> in the hands of the lender. This, at the time, created an impression that s 7C was brought in to curb the avoidance of tax avoidance as the tax implications on the forgone interest constituted income tax instead of estate duty.

There were no exemptions provided for in this initial draft legislation. As a result, an impression was created that all trusts, of any type and any residency, were impacted by s 7C. In other words, it appeared that local and offshore trusts and vesting and discretionary trusts were all impacted by s 7C.

As expected, this was not welcomed by the industry and as such, various industry bodies within the Tax fraternity partook in discussions with the regulatory bodies. Following from the discussions and comments submitted by the public, the second draft of this legislation was released in September 2016.

The nature of the forgone interest was amended from gross income to a <u>donation</u>, thereby subjecting the forgone interest to donations tax in the hands of the lender.

Although this was in line with the recommendations by the DTC and the National Budget Speech, it confirms an element of confusion by the regulatory bodies in respect of whether s 7C is aimed at the avoidance of tax or estate duty. This also confirmed some, if not all the views outlined in the bullet points above.

Furthermore, the second draft introduced a list of exemptions from the ambit of s 7C. Most of the exemptions were highly welcomed by the public. Some exemptions, although they were welcomed by the public, they either create interpretation issues or leave taxpayers with more questions than answers. These will be discussed in the study below.

Nevertheless, this section was promulgated into law in January 2017 and is effective from 1 March 2017.

2.2 Introduction of section 7C

SARS and NT succeeded their attention on trusts with an addition into the tax legislation. The new s 7C was promulgated in January 2017 and is effective from 1 March 2017. This section applies to loans entered into from 1 March 2017 and also applies to loans entered into prior to 1 March 2017 that are still in existence on 1 March 2017.

However, this section is aimed at only one type of funding mechanism in respect of trusts and does not expand to other ways in which trusts are funded. Section 7C focuses only on interest-free or low interest loans granted to trusts and looks to curb the estate duty avoidance resulting from this funding mechanism. In effect, s 7C deems the forgone interest resulting from interest-free or low interest loans to be a donation in the hands of the lender.

Although loans are a popular manner of funding trusts, there are other mechanisms which are used to fund trusts, namely by way of an outright donation, sale of assets to trusts or bequeath of assets by the lender/ donor. Bearing this in mind, it remains an unanswered question as to the reason for the introduction of this section. It may be that, although there are other funding mechanisms which the Act already addresses in terms of their tax implications, interest-free or low interest loans remained the only funding mechanism which was yet to be addressed by the Act, perhaps from an estate duty point of view.

In so saying, it further remains questionable as to whether this section achieves its goal as envisaged by both SARS and NT.

3. CHAPTER 2 – THE PROVISIONS OF SECTION 7C AND ITS REQUIREMENTS

Section 7C relates to loans or credit advanced to a trust by a connected person. For the purposes of this study, loans and credit will be collectively referred to as loans.

This section applies where the loan is provided by a natural person or at the instance of that person, a company in relation to which that person is a connected person. The connectivity in respect of a loan advanced by a company, is applicable only where the person, other than a company, individually or jointly with any other connected person/s in relation to that person, holds, directly or indirectly, at least 20 per cent of the equity shares in the company or the voting rights in the company.

In other words, the loan must be provided by a natural person or a company wherein the person granting the loan holds 20 per cent or more of the equity or voting rights. Where this is the case, the applicability of s 7C must be considered.

The loan can be provided either directly or indirectly by the natural person or company. The natural person and the company must be connected persons in relation to the trust to which the loan was provided.

It must be noted that the connected person test is also extended to any other person who is a connected person in relation to the natural person or the company. In other words, s 7C may apply in the following instances –

- Where a connected natural person provides a loan, directly or indirectly to a trust;
- Where a company, at the instance of that person, provides a loan, directly or indirectly to a trust. Such person must hold at least 20 per cent voting or equity rights in that company;
- Where a connected person in relation to the natural person (in bullet point one), directly or indirectly provides a loan to a trust; or
- Where a connected person to a person who holds at least 20 per cent in a company, directly or indirectly provides a loan to a trust.

Lenders who will be considered for s 7C in relation to a natural person -

In relation to a natural person, a beneficiary of a trust is a connected person in relation to a trust. Meaning that should a beneficiary directly or indirectly grant a loan to a trust, the applicability of s 7C must be considered. Furthermore, any connected person in relation to a beneficiary of a trust is also a connected person in relation to the trust. It is this extension in respect of connected persons that catches most, if not all, loans to a trust in respect of natural persons, for purposes of s 7C.

In most cases as evidenced in the practical world, a loan to a trust is ordinarily granted by the donor. Although the donor may not be the beneficiary of the trust, he is in most instances a connected person in relation to the beneficiary of the trust and as such, these types of loans are in scope for consideration of the applicability of s 7C. If the donor and the beneficiary are relatives[6] as defined in the Act, they are connected

[6] A relative in relation to any person is defined as the spouse of such person or anybody related to him or his spouse within the third degree of consanguinity, or any spouse of anybody so related. For the purpose of determining the relationship between any child referred to in the definition of 'child', such child shall be deemed to be related to its adoptive parent within the first degree of consanguinity.

persons in relation to each other and consequently, this makes both of them connected persons in relation to the trust.

For example, a father creates a trust and his child is a beneficiary of such trust. A loan granted by the father as the donor and not the beneficiary must be considered for s 7C as the father and child are connected persons in relation to the trust.

It is a general view that the public has been deterred from trust structures purely due to the introduction of s 7C. However, the applicability thereof is not always considered upfront. Therefore, care must always be taken in determining the applicability of s 7C in respect of natural persons

Lenders who will be considered for s 7C in relation to a company –

The requirement in respect of a company is a direct or indirect shareholding (of either equity or voting rights), individually or jointly with any connected person in relation to each other, of 20 per cent or more in a company. Therefore, where the shareholding is less than 20 per cent, the loans from the company to the trust are not impacted by the provisions s 7C. No tangible reason for this was provided by the regulatory bodies.

This requirement for a minimum shareholding leaves room for the avoidance of s 7C through the use of interposing companies where there is less than 20 per cent shareholding. The regulatory bodies have awaken to this gap and as alluded to in the 2017 National Budget Speech, there may be an amendment in future to include all companies where there is shareholding of any percentage, instead of the minimum requirement of 20 per cent. This will be discussed further in the study below.

Section 7C states that where the trust incurs no interest on the loan provided or incurs interest at a lower rate than the official rate of interest as defined in paragraph 1 of the Seventh Schedule, the interest forgone will constitute a donation by the lender to the trust. The official rate is currently 8 per cent, being the South African repo rate plus one per cent. This means that the official rate of 8 per cent is not fixed but will fluctuate as the repo rate fluctuates.

In a situation where the loan is provided by a company to a trust, each shareholder in that company will be treated as having donated to that trust, a part of the loan amount that bears to the total loan amount the same ratio as the equity shares or voting rights in that company were held by that person during that year of assessment bears to the equity shares or voting rights in that company held in aggregate by those persons during the year of assessment.

For example, a company that has 5 shareholders each with 20 per cent shareholding of equity shares, grants an interest-free loan of R10 000 000 to a trust. Each of the shareholders will be treated as having provided an interest-free loan of R2 000 000 to the trust. The forgone interest of R160 000 (R2 000 000 * 8%) will be deemed to be a donation from each of the shareholders to the trust. Where applicable, the annual exemption of R100 000 on donations may be used.

Subsection 5 of s 7C lists all the exemptions from s 7C as follows:

- A public benefit organisation approved by the Commissioner in terms of s 30(3) of the Act or a small business funding entity approved by the Commissioner in terms of s 30C of the Act;
- A fully vested trust where all the beneficiaries have a vested right to both the capital and income of the trust;
- A special trust created solely for the benefit of one or more persons who is or are persons with a disability. This exemption does not extend to a special trust created for minor children;
- A loan partly or wholly used by the trust for the acquisition of a primary residence and the primary residence was used by the lender or his spouse as a primary residence as contemplated in paragraph (b) of the definition of "primary residence" in paragraph 44 of the Eighth Schedule to the Act;
- A loan that constitutes an affected transaction as defined in s 31(1) of the Act;
- A loan advanced to a trust in terms of sharia complaint financing arrangements as per s 24JA of the Act, had that trust been a bank as defined in that section; or
- A loan that is subject to the provisions of s 64E(4).

Some of these exemptions will be discussed in detail in the chapters that follow, in order to highlight the impracticalities thereby caused.

The above outline of the provisions of s 7C only discusses aspects of this legislation that are relevant to the study at hand. It must be noted that the legislation consists of other provisions which, due to their irrelevance to the study, have not been outlined and discussed above.

4. CHAPTER 3 – THE PRACTICAL APPLICATION OF S 7C AND ITS INTERPLAY WITH OTHER SECTIONS OF THE ACT THAT ARE AIMED AT TRUSTS

As outlined above, to a naked eye, the provisions of s 7C may appear easy to apply. However, various impracticalities were foreseen by the tax industry.

The section requires there to be an advancement of a loan. However, a loan or credit has not been defined in the Act. This therefore leaves room for different interpretations by taxpayers. For instance, is a loan or credit only a written agreement between two or more parties or does it also include a verbal agreement between parties?

With the absence of a definition in the Act, one may resort to definitions provided in the dictionaries. A loan is defined in multiple dictionaries as –

"*A thing that is borrowed, especially a sum of money that is expected to be paid with interest"; or*

"A loan is the act of giving money, property or other material goods to another party in exchange for future repayment of the principal amount along with interest or other finance charges"; or

"A loan is a written or oral agreement for a temporary transfer of a property (usually cash) from its owner (the lender) to a borrower who promises to return it according to the terms of the agreement, usually with interest for its use. If the loan is repayable on the demand of the lender, it is called a demand loan"

In applying the above definitions to s 7C, it can be seen that a loan is an act of lending money to a borrower for a return of future payments and <u>expected</u> interest payments (emphasis). It is evident from this that future repayments towards a loan are expected to be accompanied by interest charges. However, an expectation of something is merely an anticipation and not necessarily mandatory. It follows therefore that there is no mandatory requirement for interest to be charged on a loan. In the context of s 7C however, a question is posed as to why the regulatory bodies want to make it mandatory to charge interest on a loan and where it is not charged, they seek to punish the lender?

It was held in case law[7] that an amount must be placed for the gratuitous element arising from a loan being interest-free. Failure to execute this, resulted in a deemed donation in terms of the provisions of s 7.

Although the definition of a loan implies that charging of interest is not mandatory, it makes financial sense and has thus become industry practice within the financial services companies to charge interest on loans. As such, it is normal practice for interest to be charged on a loan. As such, this practice resulted in an arms' length[8] practise in respect of loan transactions. The Act also goes further to require connected parties to transact on an arms' length basis amongst themselves, meaning that interest must be charged on loan transactions between connected persons.

Although dictionaries and the principles of the Brummeria case can be consulted in identifying a loan, an unanswered question arises in respect of trust distributions to beneficiaries that are not taken by the beneficiaries. In other words, where a trust distributes income to a beneficiary and that beneficiary decides to not take possession of that distribution but leave it in the trust. In this case, is that amount (not taken by the beneficiary) seen as a loan by the beneficiary to the trust, where interest must then be charged?

In this case and with reference to the definitions above, this is arguably an act of giving money back to the trust and perhaps with the expectation of future repayment of that money, either in instalments or as a once off payment. In this regard, there are various elements that must be addressed in order to determine whether there is a loan or not. It must first be ascertained as to whether there was an agreement, whether verbal or written, between the trust and the beneficiary to enter into a loan arrangement. It must

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[7] C: SARS v *Renaissance (Pty) Ltd 2007 (6) SA 601 (SCA), 69 SATC 205 (SCA), 2007 4 All SA 1338 (SCA), 2007 69 SATC 205*

[8] Arms' length is an acceptable price between a knowledgeable buyer and a willing seller.

further be determined whether the distribution was donated or loaned to the trust, wherein the beneficiary no longer has rights or a claim towards the distribution or a future repayment of the distribution by the beneficiary exists, respectively, with the latter resulting in a loan arrangement.

It appears that the industry concerns in respect of a definition of a loan are not substantiated and it can be concluded that s 7C does not result in a predicament in this respect. It remains the taxpayer's responsibility to prove that a loan arrangement was indeed entered into or not.

Section 7C provides a list of exemptions. In terms of this list, a loan used for the acquisition of a primary residence is exempted from the ambit of s 7C. This exemption, amongst others, was highly welcomed by the industry as it targeted trusts which were created solely for the protection of primary residences. In essence, there should not be an avoidance of tax through funding such trusts as these trusts would ideally have been created solely for asset protection. An example of this is in respect of partners in a partnership, i.e. partners in some audit firms. Should there be a lawsuit in respect of the partnership business, their primary residences may be attached to the lawsuit. A trust is therefore created to house and thereby protect their primary residences.

Although welcomed, this exemption is either unclear or incomplete and may also result in incorrect interpretation.

It is stated in s 7C that this exemption is applicable where the loan was used for purposes of funding <u>the acquisition</u> of a primary residence (emphasis). The question that arises in respect of this exemption is what about primary residences that were constructed? Would loans used for the construction of a primary residence be exempt from s 7C or not? In principle, there should be no difference between a primary residence that is constructed or acquired.

The definition of base cost in the Eighth Schedule to the Act includes cost of acquisitions and construction as part of a base cost for an asset. This makes sense in that an acquisition or construction both achieve the same purpose and for tax purposes, they should be treated the same.

Based on this, some taxpayers may seek to apply this principle to the exemption in s 7C. This may however be in contradiction of s 7C as the section only makes reference to an acquisition. The lack of clarity of intention in this respect will result in different interpretations and application of this exemption. This may result in penalties and interest for taxpayers should SARS not interpret or apply the exemption in their favour.

Furthermore, it is not clear whether renovations and major structural improvements or repairs to the primary residence will form part of this exemption. It is yet again left to the taxpayer to decide whether or not a loan used for renovations, improvements or repairs to a primary residence is subject to the provisions of s 7C or not.

The primary residence carve out appears to be simple yet it causes endless problems for taxpayers.

Furthermore, it is required that the primary residence must be used as such, for the full tax year. This means that in the year of acquisition and the year of sale of such primary residence, one will have to pay the donations tax unless the acquisition or disposal of the primary residence is timed for the beginning of the year of assessment. This is however extremely impractical, especially when dealing with sales and acquisitions of property.

Section 7C further exempts Sharia compliant transactions from the ambit of s 7C. There are two issues that arise in this regard. One is the bad drafting of this exemption whereby it is required that the trust must have been a bank as defined. Sharia complaint transactions are ordinarily between a bank or a financier and a client of that bank. In practice, it has never been evidenced where the transaction is between a bank and a bank, where the second bank is a trust or has it been evidenced where the transaction is between a bank and a client, where the bank is a trust. This requirement of the exemption seems nonsensical as it cannot be applied in practice. It may be due to drafting error.

Additionally, on the assumption that this exemption can be applied practically, it results in a very sensitive constitutional issue. The question that arises in respect of this exemption is why are Sharia compliant financing arrangements exempt from s 7C? It cannot possibly be because interest is not charged in terms of Sharia law.

It must be noted that s 24JA of the Act discusses Sharia complaint financing arrangements and it is alluded therein that although interest is not charged from these arrangements, the margin resulting from these arrangements will be deemed to be interest in terms of s 24J of the Act. If this is the case, why is consistency not passed onto s 7C? Surely a financing arrangement in terms of Sharia law that is not between connected parties will seek to derive a margin. Same as a loan to a trust in terms of Sharia law will derive a margin on the right of use of money by the borrower. It is the view that the principle as per s 24JA, where the margin is deemed to be interest income, should be carried to Sharia compliant arrangements and the arm's length principle should also be required in respect of these transactions. Failure to do so should result in discrimination based on religious belief. This is basically a constitutional matter that must either be substantiated or amended.

The above issues may be due to bad drafting of the legislation and as such there may be future amendments to provide the required clarity. However, one exemption which is clear and direct in its drafting is the exemption in respect of affected transactions. Although the inclusion of this exemption does not create issues in respect of bad drafting, it still results in issues for taxpayers.

4.1 The interplay between ss 7C and 31

It is listed as one of the exemptions from s 7C that a loan that constitutes an affected transaction as defined in s 31(1) and is subject to the provisions of that section, is exempt from the ambit of s 7C.

An “affected transaction” is defined in s 31 of the Act as, amongst others, any transaction where that transaction has been directly or indirectly entered into between or for the benefit of a person that is a resident and any other person that is not a resident and those persons are connected persons in relation to one another and the terms of the transaction is different from any term that would have existed had those persons been independent persons dealing at arm’s length.

In essence, an affected transaction is one that takes place between a resident and a non-resident who are connected persons and the transaction is not at arm’s length. The definitions of arm’s length and connected person in relation to a trust have been provided above.

The above means that a loan from a lender to a trust, where the trust and the lender are connected persons and one is resident and the other is not a resident of South Africa and the terms of the loan agreement are not at arm’s length may be exempt from s 7C.

In South Africa, a relationship that results in an affected transaction has mostly been evidenced where a South African resident donor advances an interest-free loan to his offshore trust[9].

The cross-examination of this exemption commences with the question as to whether a blanket view can be applied to the effect that all offshore trusts are exempt from the ambit of s 7C. This though, does not appear to be the intention of the regulatory bodies. If it were the case, the exemption would have directly stipulated that offshore trusts are exempted from s 7C. With this in mind, the intention of the regulatory bodies must be interrogated to ensure a clear understanding and accurate application of this exemption.

It follows from the above that there must first be an affected transaction and secondly, the provisions of s 31 of the Act must apply to that affected transaction before an offshore trust can be said to be exempt from the ambit of s 7C. In other words, where an interest-free or low interest loan is provided by a connected resident to a connected offshore trust and the provisions of s 31 apply to that loan, s 7C will not apply.

The above basically means that once it is determined that there is an affected transaction there must be a tax benefit[10] as a result of such affected transaction. In this respect, the provisions of s 7C will not be applicable and the provisions of s 31 will apply. In this case, a primary and where applicable, a secondary adjustment will be made by the taxpayer in his/her taxable income to account for the amount of the deemed foreign interest at an arm’s length rate and where applicable, the donations tax for the relevant year of assessment, respectively.

There are views in the industry to the effect that if loans that are subject to s 31 are exempt from s 7C,can the 8% official interest rate as required by s 7C be used as a guideline for an arm’s length rate in respect of loans to offshore trusts? This is due to

[9] An offshore trust is one that is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.
[10] Tax benefit includes any avoidance, postponement or reduction of any liability for tax.

the fact that the industry at large has been seeking guidance in respect of determining a market related interest rate in respect of loans to offshore trusts.

In this respect, it has been viewed by the industry that perhaps the interplay of s 31 and s 7C implies that an interest rate of 8% may also be accepted in the context of affected transactions.

The view of this study is that there is no ambiguity or issues in respect of the interplay of these two sections. The intention of the regulatory bodies is very clear in that where one section applies, the other does not apply. Furthermore, there is nowhere in s 7C or s 31 stating that the acceptable interest rate for affected transactions is implied to be 8%.

It follows therefore that the two sections need to be separated and so should the acceptable interest rates in respect of these sections of the Act. In determining the market related interest rates in respect of loans to offshore trusts, the provisions in the Seventh Schedule to the Act, amongst others, must be considered. Furthermore, all circumstances of the case at hand must be taken into account. This may include the following factors:

- The nature and purpose of the loan;
- The market conditions at the time the loan is granted;
- The principal amount, duration and terms of the loan;
- The currency in which the loan is denominated;
- The exchange risks borne by the lender or borrower;
- The security offered by the borrower;
- The guarantees involved in the loan;
- The credit standing of the borrower; and
- The interest rate prevailing at the time of the arrangement.

In practice, the taxpayer needs to be able to substantiate the arm's length interest rate in respect of the loan to the trust and due to the perceived difficulty around this taxpayers are, without valid reasons, indicating that s 7C results in a problem where s 31 is concerned. This is not the case, and it is concluded herein that the regulatory bodies have succeeded with the drafting of s 7C, where s 31 is concerned.

However, the examinations of the exemptions in s 7C make no mention of the interplay of this section and the provisions of s 7. This means that both ss 7 and 7C may apply in respect of the same loan.

4.2 The interplay of ss 7C and 7

Section 7 is very wide in its application to donations, settlements and other dispositions. However, the provisions of this section have been used for both local and offshore trusts. The specific sections relevant in respect of donations, settlements and other dispositions applicable to trusts are ss 7(2), 7(3), 7(4) and 7(8). Section 7(8) is specifically applicable in the context of an offshore trust whilst the other sections are applicable in respect of local trusts.

It is stated in s 7(8) that, amongst others, '*where by reason of or in consequence of any donation, settlement or other disposition made by a resident, any amount is received by or accrued to any person who is not a resident, which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition'.*

On the other hand, the provisions of ss 7(2), 7(3) and 7(4) all allude to donations, settlements and other dispositions between married persons and to children. However, there is no mention of the residency in this respect. Although this is the case, it is industry practice for these provisions to be applied in respect of local trusts as s 7(8) is specific to an offshore trust context.

In essence, the above provisions, popularly referred to as the 'donor attribution rules' indicate that where an interest-free loan or low interest rate loan is advanced to either an offshore trust or local trust, the interest that is not charged on the loan by the lender constitutes a disposition to the trust thereby triggering the applicable provisions of s 7. In essence, the income received or accruing to the trust in relation to that forgone interest is deemed to be income in the hands of the donor. Where these rules apply, the South African resident must include in his/her gross income the amount of income attributable to him/ her as the lender and may claim a pro rata deduction for allowable expenditure of the trust in respect of the forgone interest.

The effect of the provisions of s 7 is that of a deemed donation and tax implications arise in the hands of the donor in this respect.

The South African resident is obliged to disclose any donation, settlement or other disposition in writing when submitting his/her tax return for the relevant tax year in which the donation, settlement or other disposition was made.

Where an amount of income is attributable to a donation, settlement or other disposition, then the total amount of income which can be attributed to the resident donor is limited to the amount of the benefit derived by the trust from that donation, settlement or other disposition, being the benefit derived from the forgone interest. The donor will be subject to tax on the attributed income.

As stated above that the income of a trust may be taxed in the hands of the donor or the beneficiaries, the attribution rules may result on double taxation especially in a case of a vested trust. In order to avoid double taxation that may be caused by the attribution to the donor and a distribution to a beneficiary, it is provided that to the extent that any income of the offshore trust that has been subject to tax in South Africa in the hands of the donor in respect of the donor attribution rules, such amount should not be taxable in the hands of any South African resident beneficiary if they are vested by the offshore trust in the South African tax resident beneficiary in a subsequent year of assessment.

The provisions of s 7 have been in existence for a long period of time and their concurrent applicability with s 7C bring about two issues in respect of this study. The first issue is in respect of offshore trusts. The issue here is whether with the applicability of s 7(8), would there still be a tax benefit as required by s 31? By applying the donor attribution rules in terms of s 7(8), there should arguably be no tax benefit arising in respect of a loan to an offshore trust. If there is no longer a tax benefit due to the applicability of s 7(8), this would mean that s 31 is not applicable to the affected transaction. As such, the requirements of s 7C in respect of the exemption relating to affected transactions will not be met. Meaning that s 7C will then apply in this case. This ultimately results in both ss 7C and 7(8) applying to the same loan to an offshore trust. The question that arises is whether this concurrent application will not result in double taxation whereby s 7C taxes the donor on the donation arising from the interest forgone and s 7(8) taxes the donor on the deemed donation arising from the income of the trust derived from interest forgone?

The second issue is in respect of the need of s 7C. If s 7(8) already caters for interest-free or low interest rate loans in that there is an attribution back to the lender, why then was s 7C brought into law?

Lastly and in respect of local trusts, would the concurrent application of the other provisions of ss 7 and 7C not result in double taxation also? If s 7 already caters for the deemed donation in respect of interest-free or loan interest loans for local trusts, why is there a need for s 7C?

In addressing the above questions, the interactions between ss 7C, 7(8) and 31will be discussed.

4.3 Interaction between the tax provisions (ss 31, 7C and 7)

As stated above, the transfer pricing rules will apply where there is a loan to an offshore trust by a resident connected person which is not on an arm's length basis and this results in a tax benefit (i.e. an affected transaction). The donor attribution rules apply to any loan by a resident where no interest is charged or where interest is charged at less than a market-related rate of interest, and these rules attribute the actual income earned (by consequence of the forgone interest) by the offshore/ local trust to the donor.

Accordingly, below is a consideration of possible scenarios which may arise in the context of an interest-free loan made by a South African resident beneficiary to an offshore trust.

Scenario: An interest-free loan of R1 million is advanced to an offshore trust. The trust's income for the year of assessment is $2 million and it is assumed that $1 million of this amount was derived as a result of the forgone interest on the loan and the other $1 million was derived as a result of the loan advanced. The donor attribution rule would apply to attribute $1 million of such income to the donor. It must be noted however that the maximum amount of income that may be attributed would be equal to the market-related rate of interest which would have been payable on the capital amount of the loan, i.e. $2 million * a market related interest rate.

In the scenario above, it is assumed that there is an affected transaction and a tax benefit is derived. As such, transfer pricing rules apply and s 7C is therefore not applicable.

As noted above, the donor attribution rules will seek to attribute to the donor the income amount equalling the market related rate of interest which would have been payable on the loan amount. This means that a market related interest rate must first be determined in order to apply the donor attribution rules. If the attribution of the trust's income results in the taxable income of the donor being the same as it would have been had a primary adjustment been made under the transfer pricing rules, then there is no tax benefit and therefore there is no requirement for a primary adjustment. This means that the provisions of s 31 will not be applicable.

However, if the taxable income of the donor after the attribution of the trust's actual income is less than his/her taxable income would have been if a market-related rate of interest had been charged on the loan, that difference represents a tax benefit to the donor and the transfer pricing rules will apply.

Where there is no income arising in the offshore trust in a particular tax year, there should be no attribution to the donor under the attribution rules. However, where the loan is interest-free or interest is charged at less than an arm's length rate, the tax benefit for the donor will be the amount by which a market-related rate of interest exceeds the actual interest charged on the loan. The transfer pricing rules will apply to deem the donor to have earned a market-related rate of interest on the loan and the donor should make an adjustment to his/her taxable income to include an amount of deemed interest under the transfer pricing rules. In this case, the transfer pricing rules apply and s 7C will not be applicable.

Although s 7C will not apply, both ss 7(8) and 31 will apply to the same loan.

It is however acknowledged that the provisions of ss 31 and 7(8) are not new in any respect and have always been applicable. However, the above serves to emphasise the need for exemption of s 31 impacted loans from the ambit s 7C. This is due to the fact that adequate provisions in the Act have always been in existence in respect of such loans and therefore a further section, in the form of s 7C is not required in addition to the above.

In addressing the issue in respect of the double taxation caused by the concurrent application of these sections, ss 31 and 7(8) are seen in the industry to apply to two different tax types and as such they should not result in double taxation. This study will not discuss this aspect and will instead focus on the interplay of ss 7 and 7C to determine whether there is any double taxation.

To note from the above arguments however is that it may be concluded that the interplay of ss 7C and 31 do not result in double taxation and the applicable exemption of s 31 from the ambit of s 7C was a well thought out aspect. Although the acceptability by SARS of the taxpayer's market related interest rate is not as clearly stipulated, this issue has always been in existence and as such it is not a concern to be brought into s 7C.

Below is a consideration of a possible scenario which may arise in the context of an interest-free loan made by a South African resident donor to a local trust.

Scenario: An interest-free loan of R1 million is advanced to a local trust. The trust's income for the year of assessment is R2 million and it is assumed that R1 million of this amount was derived as a result of the forgone interest on the loan and the other R1 million was derived as a result of the loan advanced. The donor attribution rule, as per s 7, would apply to attribute R1 million of such income to the donor. It must be noted however that the maximum amount of income that may be attributed would be equal to the market-related rate of interest which would have been payable on the capital amount of the loan, i.e. R2 million * a market related interest rate.

As noted above, the donor attribution rules will seek to attribute to the donor the income amount equalling the market related rate of interest which would have been payable on the loan amount. This means that a market related interest rate must first be determined in order to apply the donor attribution rules.

Furthermore, since the loan advanced is an interest-free loan, the provisions of s 7C will also apply. This means that, over and above the donor attribution rules, a donation will be deemed to have been made by the donor to the trust. As such, donations tax at 20% will be payable to SARS by the donor.

In this scenario, it is evidenced that the donor will be taxed on the income of the trust of R1 million (this is due to the fact that it was derived as a result of the interest-free element of the loan) as per the provisions of s 7 and at the same time, donations tax on the donation will be suffered as per the provisions of s 7C. In this respect, is this not double taxation on the same transaction, being the advancement of an interest-free loan?

It is the view that there is actually no double taxation in that the taxation brought about by both ss 7 and 7C are aimed at two different income streams and hence result in two different tax types. Section 7 taxes the <u>income</u> derived from the loan whilst s 7C taxes the <u>donation</u> triggered by the act of advancing the loan (emphasis). In other words, one is an income tax and the other is estate duty, respectively.

In this case then, it is concluded that there is no double income tax but then again there is double tax of some sort on the same loan transaction.

The interplay of ss 7 and 7C in respect of local trusts however creates an element of double tax in some way or another. Although this double taxation results due to the application of two different tax types, the lender/ donor is still subjected to double tax somehow and this is as a result of the introduction of s 7C.

Although relevant in respect of the taxation of trusts, s 25B has been excluded from the study due to its irrelevance to the subject matter of the study.

5. CHAPTER 4 – OPTIONS AVAILABLE TO TAXPAYERS WITH THE INTRODUCTION OF SECTION 7C ON EXISTING LOANS AND NEW FUNDING TO TRUSTS

Section 7C has been highly topical, resulting in taxpayers questioning the future existence of trusts. However, is this section deserving of the attention and the panic that it has been provided? Taxpayers still have other options at their disposal in respect of funding a trust and it may be premature to use s 7C as the only role player in losing interest in the use of a trust structure for estate planning purposes.

5.1 Options available to the lender in respect of existing loans

Amongst others, lenders of existing loans can partake in the following options prior to the introduction of s 7C –

- To either amend the existing loan agreement from e.g. interest-free to charging an interest rate of 8% per annum. In this case, the lender will incur tax (possibly at 45%) on the interest income earned from the trust. The trust may however deduct the interest expense for tax purposes, although this is questionable[11]. In this regard, the trust must be liquid enough to fund the interest of 8% annually. However, this is not a requirement of s 7C. In terms of s 7C, it is only required that the lender pay tax on the interest income, regardless of whether such income was received from the trust or not.

  This means that, in opting for this option, the lender must have funds to pay the required tax.

  In practice and in line with this option however, advisors in the industry have been advising lenders to ensure liquidity in the trust in order for the trust to be able to pay the lender. This will then enable the lender to be able to afford the tax on an annual basis.

  The issue with this however is that a lot of trusts are not liquid. They mainly hold investment assets or property and not necessarily cash deposits. This means that a trust in this situation will be forced into a situation to dispose all or some of its assets in order to raise funds for the lender to pay the donations tax.

  This is not at all feasible as the trust will now become of no use for its intended purpose being asset protection. There may no longer be any assets in the trust to justify asset protection and thereby risk its longevity. As such, there may therefore be no need for a trust purely due to the introduction of s 7C.

  This option appears to be impractical for taxpayers and may contribute to the dissolution of trusts.

[11] The provisions of ss 11 and 23(g) must be met before the interest expense can be an allowable expense in the hands of the trust. It has been evidenced in practice that most loans are used to acquire investment assets which are held on a capital account. In this case, the deductibility of the interest expense is highly unlikely.

Furthermore, a sale by the trust of its assets will result in capital gains taxation ('CGT'). This is a clear punishment to the taxpayer for attempting to comply with the requirements of the regulatory bodies.

It is a double attack on a taxpayer which will result in a loss of interest in trust structures. This in effect will indirectly take away from the regulatory bodies as they will lose the future tax that would have been collected from trusts.

- To do away with the loan account and have the trust pay back the outstanding capital. This depends on whether the trust has funds available to repay the loan or the trust may sell its assets to repay the loan. In this case again, CGT implications should yet again be observed in respect of this disposal. The use of a trust, after disposing assets it was meant to protect is also diminished. This is in line with the above point where the double attack will impact the interest in trust structures and thereby result in a decrease in the use of trusts followed by a consequential loss in future tax from trusts.

  Perhaps this is the goal of the regulatory bodies as there are industry views that there is a lack of full understanding of trust structures by the regulatory bodies and their basis of perceived tax avoidance is purely on the increased interest by the public in these structures. As such, in resolving their perceived abuse, they sort to eradicate the 'cause' of the problem, being trusts instead of introducing workable solutions.

- Donate the outstanding loan capital to the trust, effectively doing away with the loan after paying donations tax of 20%. This appears to be one of the most practical options. The donor can outright pay the donations tax. This will do away with the perceived view that there is estate duty avoidance. Furthermore, the lender will enjoy the annual exemption of R100 000 from donations tax if no other donations were made in the same year of assessment.

  It follows however that, over and above the donations tax suffered, the lender suffers additional ongoing donor attribution implications on the interest-free element of the loan in terms of the provisions of s 7.

  With this in mind, it appears that there is no act that is good enough for the regulatory bodies as they will still apply more tax even after paying taxation. As discussed above, this may be accepted in that there are two different tax types applicable in this respect and the regulatory bodies by introducing s 7C are targeting the avoidance of estate duty, instead of income tax.

  It is also the view that when one opts for this option, it proves that the purpose of the trust was not to avoid taxation but for estate planning purposes. It is viewed that one should not be deterred from paying tax if the purpose of his act was originally not to avoid taxation. It follows however that although this may be the case, there is an element of double taxation which may be the reason for taxpayers to be discouraged by s 7C. Although one does not intend to avoid taxation, the double attack in respect of the same transaction would cause one to either attempt to avoid the second leg of taxation (as the belief is that tax has already been paid) or be discouraged from using a trust in its entirety.

- Let the provisions of s 7C apply to the interest-free loan. As a result of this, the lender will suffer donations tax on the interest forgone as per s 7C. The exemption of R100 000 is available to the lender for use on an annual basis. However, ongoing attribution in terms of s 7 also applies. This option depends on whether the lender has funds to satisfy the applicable donations tax. Some of the above issues will also be applicable on this option as well.

  The above options, although available to a taxpayer, result in a negative impact to the taxpayer of either double taxation or dissolution of the trust in their entirely. With this in mind, it is supported by this study that the introduction of s 7C will result in a material decrease in the uptake of new trusts and where feasible, may result in the dissolution of existing trusts.

- Embark on a s 42 transaction and interpose a company between a donor and the trust. Section 42 is a section in respect of asset-for-share transactions. An asset for share transaction is, amongst others, defined in s 42 of the Act as any transaction in terms of which a person disposes of an asset to a company which is a resident, in exchange for the issue of an equity share in that company and that person, upon the disposal of that asset, holds a qualifying interest in that company.

  This section, in the context of a trust, can be applied where the trust and a company enter into an asset-for-share transaction where the trust sells an asset to the company and the company issues equity shares to the trust. In effect, the trust will become a shareholder in the company. However, in order to give effect to the avoidance of s 7C, the shareholding in the company does not meet the requirement of paragraph (d)(iv) of the definition of connected person, as required by s 7C. In other words, there must not be a shareholding of 20% and more between the trust and the company. In this respect, a loan can be advanced by the company to the trust without triggering the provisions of s 7C.

  In effect and as it currently stands, should there be an interposing company between the lender and the trust, s 7C is not applicable.

  This loophole was however identified by the industry prior to the effective date of s 7C. Structures were immediately embarked on where s 42 was used to avoid s 7C, prior to its effective date. As such, those taxpayers seem to have avoided s 7C. This is one of the aspect which renders s 7C ineffective as a company can be inserted in the structure to avoid s 7C completely. However, the question is whether these taxpayers succeeded in escaping the applicability of s 7C permanently?

  The regulatory bodies became aware of this loophole and there are proposed measures, which were alluded to in the 2017 National Budget Speech that will be brought into place to curb this loophole. Although there are proposed measures to be put in place, there are already foreseen issues by the industry in respect of the drafting of this proposed measure/s. The issues around this will be discussed below.

5.2 Options available to the lender in respect of new funding

Amongst others, the donor of a trust may use the following funding mechanisms –

- An outright donation of the loan to the trust and pay donations tax once off and at the same time, suffer the attribution in terms of s 7; or
- Sell assets to the trust <u>not</u> on loan account. This is not a very popular funding mechanism as most trusts do not have sufficient capital or funds to acquire assets and the seller is exposed to capital gains tax implications on the sale of the assets.

It follows that should a taxpayer wish to distance himself from the provisions of s 7C by not advancing a loan (whether by charging a low interest rate or no interest) he is only left with two ways to fund a new trust. As alluded to above, new trusts, in most cases, do not have capital or funds to acquire assets from the donor. So in effect, a taxpayer who wants to avoid advancing a loan to a new trust is only left with one option, being to donate the funds to the trust and suffer donations tax and income tax in respect of the attribution rules.

As stated above, it is argued that if the trust is not created for the purposes of avoiding tax, then the donor should not be discouraged to pay the donations tax. However, the attribution rules further impose income tax. This results in some sort of double taxation, as discussed above as well.

However, this 'double taxation' has always been in existence as both these provisions of the Act have been in existence for a long period of time.

Since a taxpayer wanting to fund a new trust is practically left with only one option of donating to the trust, it is clear as to why interest-free or low interest loans are popular amongst taxpayers. This was due to the fact that, only s 7 was applicable to such loans (in respect to local trusts) and there was no donations tax. This resulted in taxpayers exhausting this funding mechanism as there was some sort of avoidance, being estate duty (in the form of donations tax).

The introduction of s 7C clearly curbs the avoidance of estate duty. The tables below illustrate the taxes applicable prior to and post the introduction of s 7C.

Prior to s 7C

Type of funding mechanism	Applicability of income tax (in terms of s 7)	Applicability of estate duty (in terms of donations tax)
Outright donation to a trust	Sections 7(2), (3) and (4) applied	Donations tax in terms of s 54 applied

Interest-free or low interest loan to a trust	Sections 7(2), (3) and (4) applied	No donations tax is applicable

This table elaborates that, although a trust may have not been created to avoid taxation, there was a loophole for taxpayers, in respect of interest-free or low interest loans to local trusts. Offshore trusts have always been covered in terms of s 31. As such, a taxpayer will opt for an interest-free or low interest in funding a trust as there would be no 'double' taxation. There would only be income tax as a result of the applicability of s 7 that will result from this funding mechanism. Post the introduction of s 7C however, it can be seen that this loophole has been subsequently closed. The table below elaborates this fact.

Post s 7C

Type of funding mechanism	**Applicability of income tax (in terms of s 7)**	**Applicability of estate duty (in terms of donations tax)**
Outright donation to a trust	Sections 7(2), (3) and (4) applied	Donations tax in terms of s 54 applied
Interest-free or low interest loan to a trust	Sections 7(2), (3) and (4) applied	Donations tax in terms of s 7C applied

It can be seen from the above that the regulatory bodies' intention was to close the remaining loophole in respect of interest-free or low interest loans to trusts from an estate duty perspective and not for income tax purposes. As such, the introduction of s 7C has effectively closed this loophole. Although s 7C seems to have closed this door, there may be loopholes within s 7C that allow for the avoidance of this section.

5.3 Have all the loopholes which can circumvent s 7C been addressed?

It is well known fact that taxpayers continually create ways to circumvent the applicability of any tax legislation in order to minimise their tax exposures and to an extent, avoid taxation. As s 7C was implemented to avoid estate duty, it appears from the above tables that it may have achieved its purpose barring the fact that there may be loopholes in respect of this section.

As discussed above, it has become evident that prior to its effective date, taxpayers had already identified structures to circumvent s 7C. One of such structures is by interposing a company between a trust and a donor thereby providing loans to trusts using a company. In this case and where the connected person requirement of 20 per cent equity or voting rights holding is not met, s 7C is avoided in its entirety.

The enacted legislation, as it currently stands, gives effect to this avoidance and deems s 7C ineffective as it can be easily avoided by including a company in the trust structure.

However, NT and SARS have already identified this loophole and the Minister of Finance, in his 2017 National Budget Speech, alluded to future measures to be put in place in order to prevent the use of these structures to avoid the applicability of s 7C.

At the time of writing this research report, such proposed measures were not available for perusal and discussion. However, it is already perceived by the industry that a lot of care and attention to detail must be afforded in the drafting of these proposed curbing measures.

For example, although s 7C may be amended to apply to any company without a minimum shareholding, there is plenty of room for taxpayers to be creative in respect of debt funding especially where a company is concerned. With a company, debt funding may be disguised by a form of, amongst others, hybrid equity instruments, third party backed shares in respect of preference shares, hybrid debt instruments and back to back loans. Due to the playing field being so wide where companies are concerned, closing the one loophole may open other major loopholes. As such, taxpayers anticipate the release of an amendment to s 7C where the curbing of the use of interposing companies is addressed.

Furthermore, the in *duplum rule* has also been identified as a potential mode that may circumvent s 7C. Although this rule is not legislation, it has also been alluded to in the 2017 National Budget Speech as a future measure to be addressed to prevent it from being used for the avoidance of s 7C.

The above discusses loopholes that have already been identified by the regulatory bodies. It follows however that this section is still new and as such and with time, further loopholes will be identified and used by taxpayers.

It appears as though that all loopholes have been exposed and may be closed in future. However, as with any other section of the Act, not all loopholes are closed until they are implemented and identified by the regulatory bodies. This section, just like many others, will be continuously amended to prevent the loopholes as they are identified.

6. CHAPTER 5 – INTERVIEW RESPONSES FROM TAX SPECIALISTS AND PROFESSIONALS WITHIN THE TAX FRATERNITY

Section 7C came into effect from 1 March 2017 and as such it is a very recent legislation. The journey to the promulgation of this section was afforded a lot of attention and interrogation in the Tax fraternity. The views and opinions of industry bodies and tax professionals are important in analysing the effectiveness of this section. The views also bring an aspect of practicality in respect of this section. This study embarked on a series of interviews with various industry heads and tax professionals who deal, on a frequent basis, with s 7C and its impact to their clients or industries.

The study will provide the interview responses from each of the interviewees below and an analysis of the responses in the context of the study will follow thereafter.

In conducting the interviews, the following interview questions were posed to the interviewees:

'For a number of years, SARS and National Treasury (NT) have been focusing on trust structures with the view that there is tax avoidance in respect of these structures. Although various measures were indicated to be put in place as evidenced in the Davis Tax Committee Report on estate duty and National Budget Speech, s 7C is currently the only measure which has recently been promulgated into law. The question that arises is whether this section is effective in achieving the purpose of curbing tax avoidance'.

1. *In your view, what are some of the current predicaments that are experienced in respect of this legislation? In other words, is this section practically applicable or does it bring with it more issues for taxpayers?*
2. *Interest-free or low interest loans are not the only way to fund a trust, in your view why did SARS and NT settle for s 7C?*
3. *The Income Tax Act currently has provisions which apply to interest-free or low interest loans such as s 31 and s 7. In your view, what is the interplay between these sections and s 7C? Would you say the applicability of these sections would result in double taxation for the lender?*
4. *As with any other new legislation, taxpayers were already finding ways to avoid s 7C. Some of these have been identified and there are proposals to prevent them as alluded to in the 2017 National Budget Speech. In your view, have all the loopholes of avoiding s 7C been closed?*
5. *In your view, does s 7C curb the avoidance of tax through the use of trust structures? Would you say that, by introducing s 7C, SARS and NT were successful in curbing the avoidance of tax through the use of trusts?*
6. *Any general observations you would like me to incorporate into my dissertation?*

"It is a school of thought[12] that although the section is effective in many aspects, it does bring a number of unintended consequences. For example, the section imposes huge additional cost to taxpayers who chose to use a trust as a mechanism to protect assets that are used by small business enterprises, the so called protective trusts. Another issue that arises is that the section is causing liquidity issues where taxpayers may be forced to sell some assets in order to fund the tax bill of the deemed donation'. However, in my view, s 7C is a neat solution that is easy to administer and implement by the regulatory bodies.

In respect of the potential double taxation resulting from this section, one will have to tread very careful not to be subject to double taxation. With respect to loopholes, not all loopholes have been closed yet. One should also bear in mind that some affected taxpayers might just be planning to have the business purpose of their trust preserved, which might just be other than a tax purpose.

Ultimately, s 7C is effective in preventing a large degree of estate planning and the ultimate minimisation of estate duty. It should be noted that not all uses of trusts were

[12] Mr Leon Andre Coetzee who is the Head of Group Tax at FirstRand Bank Limited, the chairperson of the Banking Association of South Africa (BASA) and the recently appointed Commercial Member of the Tax Court.

for the purpose of tax planning. A trust is also a very effective business vehicle to protect assets. In my view, SARS and NT have harmed the business use of trusts at the gain of stopping the perceived abuse and avoidance of estate duty. The irony is that trusts that were set up many years ago will fully escape the net of s 7C as most of the funding would have been settled by now. So, the real high value trusts might just have achieved their purpose. It is only newly created wealth that SARS will be able to access. In this respect, NT should consider how to deal with long existing trusts in order to have better equity. It seems that the current generation is punished for all the sins of the past by targeting any (tax) planning they embark on".

"Alluding to some of the above views, a view was further expressed[13] to the effect that funding of trusts is not always aimed to circumvent or reduce estate duty, as SARS has assumed in the information they have supplied. The following examples prove that reasons for using trusts are not for the avoidance estate duty –

i. Holiday home – a trust is a far more enduring arrangement than a company or partnership. Many families jointly own a holiday home, and the intention was to prevent an undivided interest falling into a deceased estate, every time a beneficiary passes on. A trust is a far more enduring holding entity and the current primary residence carve out does not cater for holiday homes held in a trust for reasons totally unrelated to estate duty;
ii. Many farms could not be subdivided, and a trust was the best alternative. Farms which are held in trust to ensure all children of the entire family have access to the land that may not be divided into smaller portions. However, the loans that arose from these trusts remained in place and were bequeathed as such to the next generation; the current owner of the loan faces the implications of s 7C and one day, when sold, the attribution of the CGT as well.

    Should these trusts (farms and holiday homes) be charged interest, the trust may be technically insolvent within time as there is no third party income or rental. Where the trust owns listed shares and unlisted shares, paying interest is not tax efficient. There is thus no tax deduction in the trust to match to the taxable income now taxed in the funder's name. It follows that s 7C can result in technical insolvency should the trust pay interest and not earn any income.

NT lost faith in the SARS' application of s 7 (or the failure to apply) and the *Woulidge* case was on file but never applied as well. It is evidenced that the law was in place, yet SARS never applied it or failed to implement a team to address the tax issues facing a trust. It follows further that NT and SARS have a warped understanding of the true reasons behind a trust being used. As such, they only recognised the perceived estate duty saving, whilst completely failing to understand the comments by the Davis Tax Committee on the attribution rules, being the tax saving rules.

Although unintended, the double taxation risk is between s 7(8) on the one hand and ss 7C and 31 on the other. Due to the unsubstantiated view by the regulatory bodies, this

[13] Mr Hugo Van Zyl, a Local and Global Solutions Specialist in the FNB Fiduciary division of First National Bank.

section is not effective as very few families will incur the cost and compliance challenges purely to save tax as there is a non-tax reason for the formation of a trust".

"Another school of thought was expressed[14] that the biggest problem for taxpayers is that they are effectively locked into structures that they are unable to extricate themselves from without significant costs. To illustrate, where a taxpayer has made an interest-free loan to a trust, they face the implications of s 7C by way of a deemed donation if they don't levy interest while levying interest may be inefficient and result in a tax cost in excess of the deemed donation. Waiving the loan may result in donations tax immediately on the full amount of the capital, while the trust may not be able to repay the loan without disposing of assets. To make matters worse, certain of these trust arrangements may not have been the primary target of this provision (see below). An example of such a scenario would be where the trust has been set up for the benefit of a child to which a duty of care is owed, but is not a special trust. Other examples include trusts set up for purposes of trading (as opposed to using a company form) and trusts set up for employee share schemes. In summary, the provision achieves its purpose, but catches unintended targets as well and makes it difficult for taxpayers to restructure their affairs without significant tax implications.

The only other ways to fund a trust would be through interest-bearing loans or contributions, both of which would have tax implications in the form of income tax or donations tax. Interest-free loans have long been used as a mechanism to avoid estate duty and donations tax by avoiding a donation and by pegging the value of an estate at the value of the loan, allowing assets to grow in the trust free of estate duty and donations tax. The DTC identified interest-free loans as a problem from an estate duty perspective and recommended that the assets of a trust funded with such loans should be deemed to be the assets of the lender on death for estate duty purposes.

Of course, this proposal would have been extremely burdensome both for administrators of deceased estates and SARS. Section 7C was therefore a neater solution by dealing with the implications of the interest-free loan upfront. It must be borne in mind that the Supreme Court of Appeal has consistently held that an interest-free loan is an ongoing donation of the interest foregone in terms of our common law. In principle, therefore, SARS could have challenged such loans on the basis of existing law and sought to levy donations tax. However, this approach would necessitate a facts and circumstances test in each case as to the appropriate interest rate. Section 7C provides a neater solution by deeming a specific rate of interest (the official rate) to apply for this purpose, essentially reducing the common law principle to statute and closing the loophole.

This is a relatively simple and neat solution to the problem of interest-free loans being used as a mechanism to avoid estate duty and donations tax.

It is not intended that there should be double taxation. Section 7C ((5)(e) makes s 7C subject to s 31, which includes a secondary adjustment in the form of a deemed donation or dividend, depending on whether the lender is a company or other person. In such circumstances, s 7C would clearly not apply and no double taxation would arise.

[14] Mr Kyle Mandy who is a Partner at PwC.

Insofar as s 7 is concerned, it must be borne in mind that these two provisions address different taxes. Section 7 has the effect that the income arising from an interest-free loan is taxed in the hands of the lender and not in the hands of the borrower. However, legally, such income and assets remain the property of the trust and s 7C recognises this by deeming the interest foregone to have been donated to the trust. The situation is no different from that would have applied had the amount of the loan been donated rather than lent to the trust. In such circumstances, donations tax would apply to the capital donated and s 7 would apply to the income derived from such donation.

Loopholes have not all been closed, although interposing a company under the trust was the most obvious solution for addressing existing structures. However, the possibility of using companies for new structures remains through the use of funding instruments other than loans. Other mechanisms for avoiding the tax will continue to present themselves and are likely to become increasingly complex given the involvement of high networth individuals and the amounts involved. The general anti-avoidance regulations ordinarily referred to as GAAR provisions will, however, always be a backstop to this anti-avoidance provision.

Section 7C is likely to go some way to the avoidance of estate duty and donations tax through the use of trusts. However, it will not address the issue insofar as trusts that have managed to eliminate or reduce any loans to an inconsequential level in comparison to the value of their assets are concerned. Such trusts will still achieve the objective of avoiding estate duty by skipping multiple generations. Further measures will likely be required in this regard. It must also be borne in mind that the provision does not address the use of trusts to avoid income tax, which remains a concern to the Davis Tax Committee, SARS and National Treasury".

The interview process progressed to conducting interviews with two of the well-known specialists in the tax fraternity.

They shared their views as follows:

[15]Existing loans were able to escape the provisions of s 7C as taxpayers embarked on s 42 restructurings prior to the effective date of s 7C, as such they may have avoided s 7C. In his view, new loans that are advanced from 1 March 2017 have no escape mechanism.

He however pointed out that although the existing loans may seem to have avoided s 7C, these restructurings may be attacked by SARS on two basis, one on the GAAR principles in that the sole purpose of the restructurings was for the avoidance of tax and secondly on the fact that s 42 may have not been applied accurately.

He acknowledges however that it may be difficult for SARS to prove the existence of a tax benefit. However, should the basis of 'impermissible tax avoidance' or 'connected persons and accommodating or tax-indifferent parties' be used, perhaps an argument for GAAR may hold.

[15] Mr Dan Foster, a Tax Director at Webber Wentzel.

With respect to the use of s 42 for restructuring for purposes of avoiding s 7C, the view is that many taxpayers may have overlooked the requirements in respect of qualifying debt and this may have been applied incorrectly. There is the 18 months requirement and the pledging of security requirement, where taxpayers do not always pay closer attention to. In this respect, some of the s 42 restructures that were embarked on may not be compliant. The question in this respect is whether SARS will be able to pick these up as it is then the job of SARS to ensure the accuracy and validity of these structures.

In effect, the view is that s 7C, as it currently applies, is not at all effective as it can be merely avoided by the insertion of an interposing company in the trust structure thereby defeating the applicability of s 7C. However, s 7C is the right answer for estate duty avoidance. Post the insertion of the provisions to curb the use of interposing companies, s 7C will be effective only in its respect as a technical section but it will remain ineffective in its practicality.

With a different perspective[16], it was alluded to the fact that s 7C was in principle brought in to curb the avoidance of estate duty. The section forces lenders to charge interest on loans whereas the charging of interest is optional to the lender and should remain the case. This is substantiated by the reference to the Katz Commission. Although s 7C targets the avoidance of estate duty, CGT on death already taxes the taxpayers' wealth. As such, the need for s 7C is questioned as it creates practicality issues for taxpayers to apply this section. There is a concern of the insertion of s 7C in the Act whilst it is a provision aimed at estate duty. As such, an incorrect impression is created that s 7C was brought in to curb the avoidance of taxation.

The regulatory bodies have not substantiated their perceived view of tax or estate duty avoidance. Calculations have been conducted to attempt to elaborate this view. As a result, the findings were that more tax is actually accrued by SARS through the use of trusts by taxpayers and as such, the perceived view of tax avoidance is not justified. In effect, SARS gets more out of trust structures than lose out.

It was emphasised that if the regulatory bodies conducted extensive homework they would realise the real reason for the creation of trusts by taxpayers, which is for asset protection than the avoidance of any tax. It was questioned what the regulatory bodies would do should taxpayers dissolve their trusts and put all their wealth in the possession of their children? Would the legislation be subsequently amended to catch these structures?

Issues have been experienced whereby the impact of s 7C is unaffordable by lenders or trusts due to liquidity issues. In this respect, s 7C is challenged and it was proposed that perhaps s 7C should not have been promulgated and instead, there should be an imputation of a growth of 8 per cent on the value of the loan on an annual basis. The tax on this growth will then be obtained by SARS upon the death of the lender through estate duty or where applicable, CGT on death.

[16] Adv. Gert Van Den Bergh (Advocate) who is a director at Delport Van Den Bergh.

It is a general view that the regulatory bodies lack a full understanding of trusts and as such, they resorted to a convenient provision which will satisfy a hunger of immediate collection of tax whilst at the same time, will result in a negative impact on trust structures.

Section 7C is a good way of achieving the purpose of immediate collection of estate duty although the impact of this was not considered. It is evident that administering the current provisions in the Act on taxpayer's affairs is a big issue for the regulatory bodies and if this is not resolved, we stand to see sections of such nature being continuously inserted into the Act. In the context of s 7C and the avoidance of estate duty, it was acknowledged that this may be the end of any further work by the regulatory bodies.

It is evidenced from the interview responses that there are issues with s 7C and the constant view is that the Act already consists of relevant sections which the regulatory bodies could use in achieving the same purpose that s 7C is aimed at achieving. The issues around the affordability of the tax burden are a general theme which the regulatory bodies do not seem to seek to entertain. It is also a general view that s 7C is currently ineffective however it will, in the future, be effective. However, it remains the view that this section is merely a neater and more convenient section for the regulatory bodies to cover their failure to administer the application of the currently existing provisions in the Act.

7. CHAPTER 6 – CONCLUSION

7.1 Does s 7C achieve the goal of SARS and NT in curbing the avoidance of taxation through the use of trust structures?

Section 7C only focusses on one type of funding mechanism whilst there are other ways of funding trusts. However, the Act already consists of sections therein that subject these funding mechanisms to taxation.

Due to their warped understanding of trust structures, the regulatory bodies based their perceived view of tax abuse and to an extent the abuse of estate duty mainly on the popularity of trust structures and a particular trust funding mechanism, being the advancing of interest-free or low interest loans.

Although the perceived avoidance is unsubstantiated, the study above elaborates that interest-free and low interest loans to local trusts was the only remaining funding mechanism which did not give rise to an immediate estate duty. As such, the introduction is effective in curbing the only door that remained opened for abuse by taxpayers. There are, however, other ways to collect this tax without damaging the existence of trust structures.

This section brought with it various issues in respect of potential differences regarding interpretations of some provisions, a risk of dissolution of trusts and potential double taxation. Furthermore and as it stands, companies can be used to completely avoid the application of s 7C. It must be noted that it is the ultra-wealthy trusts where there would ordinarily be an interposing company. As such, it can be argued that it is in these trusts that the regulatory bodies have a chance of collecting material donations tax in respect of s 7C.

However, interposing companies nullify the applicability of s 7C in respect of trusts where most equity is sitting. This completely renders this section ineffective currently and takes away the opportunity of the regulatory bodies to collect feasible donations tax.

It is a concluding view that this section will be effective upon the inclusion of the curbing measures in respect of interposing companies. It follows however that should it be failed to apply the required care and attention in drafting these curbing measures, s 7C could be an inadequate section in the Act.

Depending on the anticipated future amendments in respect of companies, it is a temporary view that s7C will be effective in curbing the unsubstantiated avoidance of estate duty.

However, the build up to s 7C created an impression that the regulatory bodies perceive an avoidance of taxation through the use of trusts, and not so much estate duty. Section 7C is the resultant legislation of this build up. As such, an impression was created in the industry that this section was brought in to curb the avoidance of tax, as could be seen in the first draft of this section, where the forgone interest constituted gross income.

As such and although the provisions of s 7C are somewhat effective in limiting the immediate avoidance of estate duty, the regulatory bodies have completely not focused on the avoidance of taxation through the use of trusts. As such, s 7C is not at all effective in the curbing of the avoidance of taxation. This could perhaps indicate that future legislation may be inserted in the Act, with the aim of curbing the avoidance of taxation. Perhaps the work of the regulatory bodies on trusts is not done.

It is therefore concluded that, although s 7C will in future be effective in curbing the avoidance of estate duty, it is more of a convenient, easier and neater to administer section for the regulatory bodies. In essence, the Act consists of provisions applicable to curbing the perceived abuse and there is no reason for the regulatory bodies to seek to punish the taxpayers by imposing immediate estate duty, which can be obtained at a later stage and in doing so, avoid the risk of the continuation of trust structures.

Perhaps South African tax legislation is headed towards a direction where immediate revenue collections prevail over the long term sustainability of structures which are of value to both taxpayers and the regulatory bodies, in respect of estate planning and durable tax collections.

8. APPENDICES

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